PORT OF SEATTLE
MEMORANDUM

COMMISSION AGENDA
ACTION ITEM

Item No. 6a

Date of Meeting December 11, 2012

DATE: December 6, 2012

TO: Tay Yoshitani, Chief Executive Officer

FROM: Michael Burke, Director, Seaport Leasing and Asset Management

SUBJECT: Authorization of 13th amendment to the Lease with Total Terminals, Inc. at Terminal 46

ACTION REQUESTED:

Request Commission authorization for the Chief Executive Officer to execute the 13th amendment to the lease for Terminal 46 with Total Terminals, Inc., substantially as drafted in the attached amendment.

SYNOPSIS:

This proposed amendment to the Terminal 46 lease would extend the lease term by ten years to December 31, 2025. As part of this proposed amendment, the land rent for Terminal 46 changes to a minimum annual guarantee (MAG) of revenue per acre plus a container volume lift rate fee, when applicable, to the Port of Seattle (Port). This represents a strategic realignment of the Port's container terminal lease rate making the Port of Seattle more competitive. This amendment also transfers ownership of the container cranes at Terminal 46 to the tenant and also commits the Port to certain capital improvements to the terminal.

BACKGROUND:

Total Terminals, Inc. (TTI) is the current tenant at Terminal 46. Hanjin Shipping Lines is the majority owner of TTI. Hanjin leased Terminal 46 in 1990, and later in 2003 assigned that lease to TTI. Hanjin is part of the CKYH alliance, which also includes COSCO, K-Line and Yang Ming. K-Line and Yang Ming operate terminals in the Port of Tacoma.

Terminal 46 is an important component of the container terminal inventory, generating approximately 20% of the container cargo passing through the Port. Cargo volumes at Terminal 46 are currently estimated to annually generate 3200 direct, induced and indirect jobs. In addition, current activities at the terminal are estimated to annually generate over $370,000,000 in business revenue and over $24,000,000 in state and local taxes. Maintaining Terminal 46 as an operating container terminal is key to the Port meeting its Century Agenda strategies of increasing container volume in Seattle to 3.5 million teu's and doubling the value of exports from Seattle.

TTI's lease for Terminal 46 expires on December 31, 2015. TTI has an option for a ten year extension that expires at the end of this year if not executed. This option calls for lease rates to continue at the rate that currently applies to all of our international container terminals (the "Eagle Rate," based on the T-5 lease that first established this rate with Eagle Marine Services). TTI has made it clear to the Port that it would not extend its lease at the "Eagle Rate", in part because lease rates in Tacoma increase at a slower rate than the Eagle Rate.

With the global economic downturn, carriers and terminal operators are losing money with their operations and actively seeking to reduce these losses, hence cost is a key driver. There is overcapacity in both the vessel fleet and in North American terminals that is driving decision making around reducing losses. Container volumes in the Pacific Northwest (PNW) are off their record levels of a few years ago. We do not see carriers and terminal operators making investments and expanding operations in the PNW. The port has already seen the shift of a substantial piece of container business in 2012 to a Tacoma terminal operator based on the ability to realize cost reductions there. The fact that the Puyallup tribe and their partner SSA have been unable to find a customer for their proposed terminal in Tacoma demonstrates the weak demand for terminal space. It is considered critical to retain TTI as a tenant of Terminal 46 so that it remains an active cargo terminal. Given the above, it is not likely that the Port would find a replacement tenant in the 5-10 year horizon.

The proposed lease amendment for Terminal 46 will extend the lease by ten years. The land rent will change from a per acre rent based on the Eagle Rate to a per acre MAG rent plus a container volume lift rate fee, when applicable. This proposed rate will be less than the Eagle Rate over the long term, but will keep the Port competitive with the market rates in the PNW. Due to the transparency of leases at public ports, it is common that lease rates be kept in line with each other within a port. Port of Seattle's "most favored nations" (MFN) clause in our other container leases will mean that this rate will also be offered to Terminals 5, 18 and 30.

This lease extension represents a strategic realignment of the Port's container terminal lease rate, commonly known as the Eagle Rate; this shift to a volume-based rate structure better aligns port and tenant goals to increase cargo volumes. This simultaneously yields a more market-competitive position to sustain and grow the Port container business in the face of growing West Coast and global competition.

The proposed amendment also transfers ownership of the container cranes at Terminal 46 to the tenant for a nominal fee. Again, due to the MFN clause, this crane incentive causes a lesser impact to Port revenues than lowering the basic land rent even more. This also supports the industry trend and the Port's long term strategy of getting out of the obligation to purchase and maintain cranes, allowing the Port to use scarce capital funds for more critical needs. Three of the cranes at Terminal 46 are approximately 10 years old, half way through their useful life without upgrades, and two are at the end of their useful life and are too small for many of the ships that call at Terminal 46.

As is normal for a lease extension agreement, this proposed lease amendment commits the Port to a number of capital improvements and changes some of the maintenance responsibilities with the aging infrastructure of the terminal. These are detailed below.
Per the MFN clause in our other container leases, this new land rent will be offered to our other terminal operators. Any changes to these leases will be part of future Commission actions specific to those leases.

PROPOSED LEASE TERMS:

1. The lease term will be extended by ten years to December 31, 2025.

2. As compensation for the extensive impacts and disruptions from the highway construction near the terminal, the Port will pay TTI $4,000,000 upon execution of the amendment to the lease. This amount will be funded from Seaport operating revenues.

3. The rent will be based on a MAG per "billable" acre plus a container volume lift rate fee, when applicable, starting on January 1, 2013. A billable acre is based on the recognition that some terminal acres are not suitable for container yard operations and are thus assigned a fraction of a full MAG acre. These fractions are added together to create billable acres Initially, the MAG is based on 2100 container lifts per billable acre which equates to a $50 per container lift rate (Note: Lessee must pay not less than the MAG per billable acre, regardless of how many container lifts per billable acre pass through). The container volume lift rate fee starts at $15 per container at any point in the year when the container lifts exceeds the MAG volume for that year from all billable acres. The MAG beginning in 2013 is $105,000/acre. The MAG volume rises to 2300 boxes per acre in 2016. The MAG and container volume lift rate fee increase every year as described in the attached copy of the draft lease amendment.

4. The Port will sell to TTI the five active cranes currently at Terminal 46 for $1.00/crane as of January 1, 2013. TTI will have the option to request and reimburse the Port for purchase of two new Super Post Panamax cranes. The Port will construct any electrical upgrades necessary to accommodate these new cranes. TTI will reimburse the Port for its total costs for the new cranes and related improvements, including purchase and construction costs, related taxes, engineering and management costs, and overhead costs, through a special improvement rent. The special improvement rent will be based on a twenty year return on investment to the Port with an interest factor calculated at the Port's cost of capital plus 3%, with the resulting interest rate not less than 6%. TTI must exercise this option by January 1, 2018.

5. The Port will construct capital improvements to the terminal, including extending the upgraded container dock by 200 feet, overlaying pavements sections in need of repair on the terminal, upgrading the terminal lighting control system, adding three crane pin down points and putting covers over existing fender system to improve line handling. The Port will also construct capital improvements to the storm water system to meet current standards. TTI will be responsible for operational and maintenance measures to meet

those standards. These capital improvements are estimated to cost between $20 to $35 million dollars.

6. The Port agrees to take over maintenance of the underground electrical and water systems, as well as, the electrical switch gear on the terminal. This amendment also confirms the Port's responsibility to maintain the dock structure, which has always been the regular practice of the Port.

7. The Port will change the leasehold tax formula calculation to match how the Port of Tacoma calculates that tax.

8. The Port, at its option, can accelerate the January 1, 2018, standard for drayage trucks serving the container terminals to January 1, 2016.

9. The Port will not pursue any claim against TTI concerning the recent transformer failure at the terminal.

10. Repayment of the 2009 shortfall balance is delayed to 2015.

11. The tenant's obligation to pay two $600,000 payments if the tenant did not achieve certain minimum volumes in at least two of the next four years is eliminated. The tenant was expected to achieve this requirement in any event.

12. Additionally, the Port and Lessee recognize the potential threat to Lessee's operations posed by the possible construction of a new multi-purpose indoor sports arena in the Stadium District (Arena). Lessee is concerned about the impacts such a facility would have on traffic congestion in the area and that such congestion could have a negative impact on the Premises' operations. The Port and the Lessee will work together to protect Lessee's efficient operations at the Premises that are affected by the Arena. Lessee and the Port will devise other measures, as mutually agreed between the parties, to lessen the discernible impacts of the Arena if it is built.

FINANCIAL IMPLICATIONS

Source of Funds

The proposed lease amendment requires funding of a one-time $4 million operating expense, capital investment obligations estimated between $20 million and $35 million, and incremental maintenance operating expenses initially estimated at $200,000 per year. The tenant also has the option to request the Port to purchase two new cranes and provide necessary electrical upgrades to Terminal 46 to accommodate those new cranes, with an estimated cost of $25 million fully installed (subject to TTI reimbursement as explained above in Proposed Lease Terms, item 4).

The $4 million impact fee is payable to TTI upon execution of the lease amendment, which is expected to occur in early 2013. The $4 million impact fee and the $200,000 in incremental maintenance expenses were not anticipated in the 2013 operating budget. These costs will be funded by the General Fund. In future years, the Port obligation for incremental maintenance expense will be included in the annual operating expense budget.

The Port's obligation for capital improvements to the terminal under the terms of the lease amendment are estimated between $20 million and $35 million. If the tenant exercises the option for (2) new cranes, the Port's capital improvement obligation increases by an additional $25 million. The 2013 Budget included $40 million under CIP # C102554 for Terminal 46 development associated with leasing the terminal after the current lease term ends on December 31, 2015. These projects will be funded from the general fund.

Financial Analysis Summary

CIP Category	N/A – *the request for funding authorization to construct the capital improvements required by the lease amendment will be presented in a subsequent Commission Memo*
Project Type	N/A
Risk adjusted Discount rate	9.0%
Key risk factors	**Key risks of MAG program:** • The MAG program reduces guaranteed revenue to the Port and increases volatility in Port container terminal revenue. • Lower guaranteed revenue and increased volatility will reduce the future borrowing capacity of the Seaport Division. • Revenue to the Port will not exceed MAG unless terminal cargo volume exceeds the Annual Premises MAG Lifts (defined as: Billable Acres x MAG Lifts per Billable Acre) in a given year. • Revenue to the Port is expected to be lower under the MAG program than the revenue that would have been achieved under the Eagle Rate, even if cargo volumes grow significantly. The differential in earnings under the proposed MAG program is due to the lower initial MAG rate per acre in 2013 and due to the lower annual rate escalation structure in this MAG program compared to the scheduled contractual increases in the Eagle Rate lease structure. • The box rates under the MAG program are subject to annual CPI rate increases: ➢ For years 2014-2018: fixed annual increases of 2% ➢ For years 2019-2025: annual increases will be the greater of two percent (2%) or fifty percent (50%) of the Consumer Price Index, but not to exceed 5% per year. • MFN clauses in the other three Seattle container terminal leases obligate

	the Port to offer the lower MAG lease rate structure to all current Port international container terminal tenants. • The proposed MAG program may not provide enough incentive in the current economic climate to retain or significantly increase cargo volume in the Seattle harbor. **Credit Risk:** • The lease amendment replaces a requirement for a corporate surety bond or other security which secured the full performance of all terms and conditions of the Lease including the payment of all amounts payable to the Port with a corporate guaranty by Hanjin Shipping Company, Ltd. • Hanjin Shipping Company, Ltd operates in a highly competitive market that is characterized by over capacity, cyclical rates and volatile petroleum prices. • Information available suggests that Hanjin Shipping Company is more highly leveraged than other comparable companies which will give it less flexibility in the event of market turndowns.
Project cost for analysis	• \$20 - \$35 million for capital improvements specified in the amendment • An additional \$25 million investment if the tenant requests (2) new cranes
Business Unit (BU)	Container Operations
Effect on Business Performance	Following is an estimate of the incremental impact of the 13th amendment to the Terminal 46 lease on NOI after Depreciation. The results shown below for years 2013 through 2018 reflect the initial six years of the thirteen year program. Incremental impacts are calculated by comparing the new MAG program to the current lease (at Eagle Rate) which terminates on 12/31/2015.

Net Operating Income – without new cranes:

NOI (in $000's)	2013	2014	2015	2016	2017	2018
Incremental Revenue	(4,687)	(5,204)	(5,075)	10,513	10,898	11,184
Incremental Expense	(4,200)	(205)	(210)	(215)	(221)	(226)
NOI Before Depreciation	(8,887)	(5,409)	(5,286)	10,297	10,677	10,957
Depreciation	-	-	(535)	(1,130)	(1,724)	(2,319)
NOI After Depreciation	(8,887)	(5,409)	(5,821)	9,168	8,953	8,639

Estimated annual depreciation is based on the \$35 million capital investment (high end of the range). Actual depreciation may be lower, if the required terminal improvements can be constructed at a lower cost in the range of estimates provided.

In addition, the sale of the existing Terminal 46 cranes to TTI will result in a non-operating loss on retirement of assets of approximately \$10 million in 2013.

If this lease extension does not occur, it is expected that Terminal 46 will become vacant when the current lease ends on 12/31/2015.

Key Assumptions Used in Analyses

Estimates for CPI increases effective for years 2019-2025:

- Estimates of future box rates under the MAG program included the full range of annual rate increases allowed under the program parameters.
- The "most likely" scenario assumes the minimum annual increase of 2.0% over the proposed 13 year program. The 2% minimum is deemed the most likely increase, since the annual adjustment is fixed at 2% through 2018 and is limited to the greater of 2% or 50% of CPI in years 2019-2025. This assumption is based on historical average CPI increases of 2.1% to 2.9%, which when subject to the 50% limitation would likely result in a factor lower than the minimum annual increase of 2%.

Estimates for cargo volume during the T-46 lease term (2013-2025):

- Estimates of future container volume patterns were developed on a terminal specific basis, using a variety of scenarios and a range of volume growth assumptions.
- The "most likely" volume scenario shown in this Effect on Business Performance section is based on current terminal volume, growing at 2% annually.
- Any new cargo service or larger vessels calling at the terminal would generate additional revenue to the Port, due to the Container Volume Lift Rate Fee applicable to cargo in excess of the Annual Premises MAG Lifts.

IRR/NPV

The incremental impact of the 13th amendment to the Terminal 46 lease is shown below. The analysis includes the MAG program from 1/1/2013 through 12/31/2025. Not included in the below calculations is the opportunity cost for land or possible future investment in facilities.

Financial Impacts – without new cranes

Terminal 46 Impact Only (range of required investment)	**NPV** (in $million's)	**IRR**	**Payback** (in years)
$20 million capital investment	**$22.2**	**18.6%**	**8**
$35 million capital investment	**$9.9**	**12.7%**	**9**

Financial Impacts – with (2) new cranes

Terminal 46 Impact Only (includes investment in new cranes)	**NPV** (in $million's)	**IRR**	**Payback** (in years)
$20M capital investment + $25M cranes*	**$13.5**	**13.9%**	**9**
$35M capital investment + $25M cranes*	**$1.3**	**9.4%**	**10**

* *Based on estimated timing: assumes tenant request for (2) new cranes received in early 2016, with an in-service date for new cranes in January 2019. Special improvement rent for the new cranes commences when the new cranes are certified and available for use.*

	Financial impacts due to MFN implications in other container terminal leases have been thoroughly reviewed with Commission. Separate Commission action will be required to amend leases at the other container terminals, in order for this MAG program to be implemented throughout the harbor.

ALTERNATIVES CONSIDERED AND THEIR IMPLICATIONS:

1. Hold to the Eagle Rate at Terminal 46: This alternative would mean that TTI would not continue to lease Terminal 46. Most likely the existing container business would move to Tacoma. It is also very unlikely the Port would be able to find any potential terminal operator for Terminal 46, given the economic climate.

2. Redevelop Terminal 46 into other uses. This alternative would result in loss of cargo capacity and family wage jobs in Seattle making it difficult for the Port to achieve the Century Agenda strategies. Most viable alternative uses of Terminal 46 can be located in other areas but the container cargo capacity cannot be replaced in the Seattle area.

3. Amend the Terminal 46 lease as proposed. This alternative results in maintaining the economic and job benefits from the cargo business at Terminal 46 in the Seattle area. **This is the recommended alternative.**

OTHER DOCUMENTS ASSOCIATED WITH THIS REQUEST:

- Draft Lease Amendment